The NewsLine

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EUROZONE

Low inflation rate no reason to expand the QE purchase program

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Eurozone inflation remains seemingly unfazed by the ECB's quantitative easing policy. Six months since the 1.14 trillion euro bond-purchasing program was launched, the rate of inflation within the eurozone is still hovering close to zero. Nevertheless, the ECB should refrain from any rash measures and make a clear decision not to expand the bond-purchasing program any further.

It would appear that the ECB is not quite as good at accurately steering inflation in the short term as many had hoped. The Eurostat flash estimate put the annual rate of inflation within the euro area at 0.2% in August, unchanged on July. Although the European Central Bank has already been buying up govern-ment bonds and other securities worth EUR 60bn on a monthly basis since March of this year in an explicit attempt to ward off the risk of deflation, the rate of inflation has barely risen over the last six months and is still lingering close to the zero mark. The development in the 5y5y forward inflation swap rate – the ECB's preferred gauge of inflationary expectations – is also likely to provide cause for concern. This rate came in at 1.60% last week, the lowest level seen since February 2015. By way of comparison, in early July the swap rate stood at 1.85%. The inflation barometer therefore suggests that eurozone inflation rates will continue to trend below the ECB's target of close to 2% in the medium term.

Although its inflation strategy is failing to have the desired effect, the ECB's Governing Council should adopt a “steady-hand” policy and opt not to take any new monetary policy measures at its meeting scheduled for Thursday.

First, we remain skeptical as regards the need for the purchase program, and, as a result, also as regards its prospects of success. In our view, the low rate of inflation in the eurozone reflects the necessary adjustment processes in the former crisis countries. By contrast, there are no signs of any deflationary trends. As a result, administering a higher dose of the wrong medicine would be unlikely to improve the chances of success of the ECB's strategy. The risks and side effects of the expansionary monetary policy on the other hand – such as the hunt for returns and risk appetite on the financial markets – would likely become more pronounced.

Second, the low inflation in the eurozone is currently due largely to external factors and special effects, with falling energy prices, in particular, pushing inflation down. The price of Brent crude oil has fallen by 24% since the start of June. Given this rapid plunge in oil prices, the fact that the annual rate of inflation in August did not slip into negative territory is rather astounding. Stripping out the energy component, the rate of inflation would have already bounced back to 0.9%.

Third, the ECB should not be tempted to step up its measures in response to the current concerns regarding a Chinese economic slowdown and its possible impact on the global/eurozone economy either. While the EMU economic recovery is not a glittering success story, upping the monthly purchases would only risk reinforcing concerns over the economy and having the opposite effect. What is more, the low inflation rates are expected to boost private consumption in the eurozone, at least partially offsetting a possible slowdown in export demand from abroad.

If ECB President Mario Draghi wants to step things up a gear, he should limit this approach to his verbal statements for the time being and hint at potential measures that could be taken should deflationary trends emerge. At the same time, however, the ECB President would also be well advised to emphasize that there is clearly no need for such measures as things stand at present.

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